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CFIUS Implements Mandatory Filing Based on Export Licensing

Key Points

- On September 15, Treasury published a Final Rule adopting changes to the CFIUS mandatory filing framework for covered transactions involving critical technologies.
- Rather than being pegged to targeted industries associated with the U.S. business and its customers, mandatory filings will be triggered by export control requirements specific to the critical technologies and foreign persons involved in the transaction.
- This "hypothetical export" analysis will apply to the investor itself and its parent entities, including entities holding, directly or indirectly, a 25 percent or greater "voting interest" in the acquiring entity.
- Eligibility for certain license exceptions may exempt transactions from mandatory filing. However, parties may need to take additional steps, such as submitting classification requests to BIS, to avail themselves of such exemption.
- The Final Rule will take effect on October 15, 2020.

Background

The Committee on Foreign Investment in the United States (CFIUS) is the inter-agency mechanism through which the United States government formally monitors and reviews foreign investment in the United States for possible national security concerns. Under the Final Rule, which incorporates minor changes to the Proposed Rule published in May (see our prior Client Alert), mandatory filing requirements for transactions involving U.S. businesses that produce, design, test, manufacture, fabricate or develop critical technologies will now be primarily pegged to export control requirements specific to the critical technologies and the foreign persons involved in the transaction rather than the target's nexus to certain targeted industries.

By leveraging the foundations of existing export control regimes, CFIUS hopes to better focus mandatory filing on transactions that present technology transfer concerns based on the nationality of the foreign persons involved in the transaction and sensitivity of the item. Under the prior framework, if the transaction lacked a nexus to the 27 specified North American Industry Classification System (NAICS) codes, it

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would not be subject to mandatory reporting even if the foreign investor presented a high threat profile or the technology developed by the U.S. business was particularly sensitive. On the other hand, some transactions involving investors from closely allied countries triggered mandatory reporting based on the nexus to a targeted industry even though the technology transfer and transaction at issue did not raise significant national security concerns.

Overview of Changes

The primary purpose of the rule is to modify the framework used to determine which covered transactions involving critical technologies are subject to mandatory filing.[1] Under the new export control-focused framework, to assess whether a mandatory filing is required, the parties to a transaction must consider whether a hypothetical export of the U.S. business's critical technologies to foreign persons involved in the transaction, including a party's parent entities and certain investors, would require a U.S. regulatory authorization under the relevant U.S. export control regime.[2]

More specifically, under the new Section 800.401(c)(1), a covered transaction involving a U.S. business that produces, designs, tests, manufactures, fabricates or develops critical technologies will be subject to mandatory filing if a U.S. regulatory authorization would be required to export, reexport, transfer (in-country) or retransfer the critical technology to any of the following:

i. A person who could "directly control" the U.S. business as a result of the transaction

ii. A person "directly acquiring" a covered investment interest in the U.S. business as a result of the transaction

iii. A person with a "direct investment" in the U.S. business whose rights are changing in a way that could result in a covered control or covered investment as a result of the transaction

iv. A person who is a party to any transaction, transfer, agreement, or arrangement designed or intended to evade or circumvent CFIUS jurisdiction with respect to the U.S. business

v. A person who holds, individually or in the aggregate as part of a group of foreign persons, a "voting interest for purposes of critical technology mandatory declarations" in any of the above persons.

Notably, the parties must consider not only whether a hypothetical export to a party that will "directly control" or that is "directly acquiring" a covered investment interest in the U.S. business will require an export license or authorization, but also identify and apply the same analysis to certain parent entities and investors in those persons' ownership chain. Under the new definition of "voting interest for purposes of critical technology mandatory declarations" under Section 800.256, any person that has a 25 percent voting interest, direct or indirect, in one of the persons identified in Section 800.401(c)(i)-(iv) (identified above) must be considered for purposes of the hypothetical export analysis.

Significantly, for investment funds, the identification of relevant persons in the ownership chain of an entity "whose activities are primarily directed, controlled, or coordinated by or on behalf of a general partner, managing member, or equivalent" is limited to the persons that holds 25 percent or more of the interest in the general

partner, management member or the equivalent of the entity. Note that for these purposes, the inquiry does not focus on the "voting interest" but rather the "interest."[3] The definition also explains when to aggregate the interests of foreign persons and how to calculate a parent entity's interest for purposes of this definition.

Applicability of License Exceptions

As a general matter, the availability of a license exemption or exception that would otherwise permit the hypothetical export of the U.S. business's critical technologies to the relevant foreign person without a license are not considered for purposes of determining whether mandatory filing requirements apply to the transaction. That said, the Final Rule permits parties to rely on the eligibility for specific license exceptions to remove the mandatory filing obligation. This exemption is in addition to the existing carve-outs from mandatory reporting under this rule (e.g., for "excepted investors," investment funds meeting specific criteria and businesses subject to certain Foreign Ownership, Control, or Influence (FOCI) mitigation).

Under Section 800.401(e)(6), as revised by the Final Rule, a transaction that would otherwise be subject to mandatory reporting under this rule would be exempt from this requirement if each hypothetical export is eligible for at least one of the following license exceptions under the Export Administration Regulations (EAR):

- **Technology and Software—Unrestricted (TSU)**, which authorizes certain exports and reexports of operation technology and software; sales technology and software; software updates (bug fixes); and "mass market" software. 15 C.F.R. 740.13.
- **Subsection (b) of License Exception Encryption Commodities, Software and Technology (ENC)**, which authorizes certain exports, reexports and transfers of certain encryption commodities, software and components. 15 C.F.R. 740.17(b).
- **Subsection (c)(1) of License Exception Strategic Trade Authorization (STA)**, which authorizes certain exports, reexports and transfers of items controlled for national security (NS), chemical or biological weapons (CB), nuclear nonproliferation (NP), regional stability (RS), crime control (CC) and/or significant items (SI) to certain countries. 15 C.F.R. 740.20(c)(1).

In addition, under the nuclear export controls, certain general licenses (i.e., 10 CFR 810.6(a) general authorization and any general license under 10 C.F.R. Part 110) would not trigger mandatory filing under the Final Rule.

The Final Rule clarifies that "eligibility" for the above EAR license exceptions means "having satisfied any requirements imposed by the EAR that must be satisfied prior to export (even if no export is to occur)." In some cases, a license exception may require the U.S. business to first submit a classification request to the Bureau of Industry and Security (BIS) prior to export. Parties wishing to rely on such license exceptions to avoid a mandatory filing must undertake the prescribed pre-export steps in order to establish eligibility. The U.S. Department of the Treasury (the "Treasury") clarified, however, that license exception requirements that do not need to be completed prior to export, such as a semiannual reporting requirement, need not be completed in order to be considered eligible for the license exception for purposes of the CFIUS regulations.

Conclusion

The new mandatory filing requirements pegged to export control requirements leverage existing laws that have been refined over decades to address technology transfer issues and therefore should limit the over and under inclusive results that could occur under the previous NAICS-based criteria. Nevertheless, the combination of the export classification/licensing analysis and the manner in which this analysis flows up through the ownership chain of the acquiring party will require enhanced diligence and complex analysis in many transactions to assess whether mandatory reporting applies.

Given the civil penalties that apply for failure to comply with a mandatory filing requirement—up to $250,000 or the value of the transaction, whichever is greater—focusing on these export control-related issues early on will become ever more important for all parties to the transaction.

1 “Critical technologies” are items that are:

- Included on the United States Munitions List (USML) set forth in the International Traffic in Arms Regulations (ITAR).
- Identified on the Commerce Control List (CCL) set forth in the EAR and controlled pursuant to multilateral regimes or for reasons relating to regional stability or surreptitious listening.
- Subject to certain nuclear controls set forth in 10 C.F.R. Part 110 and 10 C.F.R. Part 810.
- Select agents and toxins covered by 7 C.F.R. Part 331, 9 C.F.R. Part 121 and 42 C.F.R. Part 73.
- Emerging and foundational technologies identified pursuant to Section 1758 of the Export Control Reform Act of 2018 (to date, no such technologies have been identified). 15 C.F.R. 800.215.

2 The Final Rule defines “U.S. Regulatory Authorization” to mean:

- A license or other approval issued by the Department of State under the ITAR.
- A license from the Department of Commerce under the EAR.
- Certain Department of Energy authorizations related to assistance to foreign atomic energy activities.
- Certain Nuclear Regulatory Commission licenses related to the export or import of nuclear equipment and material. 15 C.F.R. 800.254.

3 This aligns with how a foreign government’s interest in an entity whose activities are primarily directed, controlled or coordinated by or on behalf of a general partner, managing member or equivalent is considered for purposes of the “substantial interest” test under the mandatory filing requirement for covered transactions involving TID U.S. businesses and a foreign government. In such cases, the relevant threshold is a 49 percent “interest,” not “voting interest.”

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